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A Balancing Act: Making the Canadian Secured Credit Facility Work

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- The 2009 federal budget proposed the Canadian Secured Credit Facility to provide financial liquidity quickly to a variety of originators of vehicle and equipment loans and leases.
- In the short term, the success of the Facility will depend on the amount of funding effectively funnelled through existing channels into financing for consumers and businesses. Early success on this front could support a case for replenishing the pool of capital available in the Facility.
- Looking ahead, the Facility could lead the development of new market standards for term securitization; if so, the Facility could conceivably improve investors' confidence, creating a sustainable marketplace for these types of asset.

The January 2009 federal budget proposed funding a "Canadian Secured Credit Facility" as part of an economic action plan. This Facility will allocate up to $12 billion to purchases of term asset-backed securities (ABS) for loans and leases on vehicles and equipment. The Facility will be managed by the Business Development Bank of Canada (BDC), which has since conducted consultations on the proposal.

Without commenting on the wisdom of, the need for, or the taxpayer risks associated with such a Facility, this *e-brief* reports on how the Facility might succeed in achieving its stated aims. The Facility's objective is to provide quickly the equipment and vehicle loan and lease financing industry with financial liquidity, presumably to facilitate businesses' and consumers' access to credit in the short run. With an allocation of $12 billion in a much larger market, however, it is unrealistic to expect the Facility to immediately or fully achieve that goal, because its impact on liquidity will be transient. Short-term restoration of normal credit conditions, therefore, could not be the criterion used to judge the program's success or failure. In the longer term, however, the Facility's success will be judged by its ability to improve investor confidence, enabling primary and secondary markets to develop and restore sustainable funding through securitization channels.

This *e-brief* draws in part on comments made by a number of market participants at the C.D. Howe Institute Policy Conference "Shaping a Canadian Secured Credit Facility," held in Toronto, March 6, 2009; the views expressed are those of the author. The author would also like to thank the reviewers who commented on earlier versions of this paper.

Background

Vehicle- and equipment-based leasing and financing represents an important source of capital for Canadian businesses, farmers and automobile consumers. At the end of 2008, the total value of outstanding asset-backed securities in Canada reached about $104 billion,[1] with about half of the total being term ABS.[2] Equipment and vehicle financing backed about $26 billion of that half share. Federally regulated financial institutions face some legal restrictions on their roles in the leasing market. Traditionally, most asset-based leasing and financing activities have been performed by the financing arms of large manufacturers or independent financial firms. In recent decades, funding for the asset-based financing industry – especially the largest companies – has been accomplished through securitization of receivables, by which process income-generating assets, such as loans and leases, are repackaged into securities and sold to investors in return for the rights to future cash flows of underlying assets. This market, however, in August 2007 ceased to operate normally.

In addition, the global financial crisis has led to a structural shift in the quantity and quality of credit provided by the worldwide banking sector, accompanied by a broad contraction in financial intermediation. The rebalancing of risks on banks' balance sheets and an unfavourable economic outlook led to a tightening of credit terms and conditions, increasing the cost of financing for asset-based financing companies, and decreasing the availability of this source of capital financing for businesses and consumers.

Making the Facility Work

From an industry viewpoint, the first challenge is for funding to flow quickly. Another challenge, presuming policymakers intend to preserve the loan and lease financing business in something like its recent form, will be balancing the needs of a diverse industry, in terms of participants' size and types of asset securitization. Smaller originators of asset-backed loans and leases may lack the resources and volume to justify the cost of acquiring the AAA ratings that many investors, and the proposed terms of the Facility, may require. For the Facility, diversifying its funding structure to reach a wider range of financing companies could increase the likelihood that funds would be effectively recycled into new lending for consumers and businesses, and that securitization channels re-emerge.

A multi-channel approach could help. The Facility could leverage the expertise of existing investment channels to better and more quickly fund the variety of originators of loans and leases. Specifically, for large sophisticated and established issuers, such as the financing arms of automobile and equipment manufacturers, the Facility could purchase new AAA tranches from existing and newly established securitization vehicles. For the mid-size originators, the Facility could channel its funding through existing or newly established multi-seller bank conduits (and other existing, regulated, conduits) by buying term securitizations issued by the conduits, and tailored to meet the requirements of the Facility. For the smallest originators, the Facility could co-invest with experienced institutional aggregators – such as large life insurers – who are already active in the marketplace managing their own private portfolios of receivables from smaller asset-based financing companies (see Figure 1).[3] For all three channels, appropriate risk-management and pricing mechanisms would need to be in place.

1 Down from about $175 billion when the market peaked in July 2007.

2 An asset-backed security is a class of debt instruments with payouts based on the receivables of a pool of assets such as leases and loans. Unlike Asset-Backed Commercial Paper (ABCP), term-ABS have longer maturities and thus do not need to be refinanced on a periodic basis.

3 Given that AAA ratings may not be accessible within the existing model for institutional aggregators, and that the Facility by design may not fund assets other than AAA-rated ones, the federal government or BDC could consider aiding such non-rated channels through other mechanisms such as the federal Business Credit Availability Program.

Figure 1: Leveraging Existing Investment Channels

Channel 1: Large Single-Seller Issuers
Large Originators and Single-Seller Issuers
Eligible loans and leases are bundled into new or existing established securitization structures.
Rating Agencies and Facility's own due diligence.
Facility purchases AAA-rated tranches.
Proceeds are used to finance more loans and leases.
Channel 2: Multi-Seller Conduits
Large and Mid-Size Originators
Eligible loans and leases from various originators are packaged into new or existing multi-seller bank conduits, tailored to meet requirements.
Rating Agencies and Facility's own due diligence.
Facility purchases AAA-rated term-ABS.
Proceeds are used to finance more loans and leases.
Channel 3: Institutional Aggregators
Small-Size Originators
Existing institutional aggregators – e.g., life insurance companies – build a portfolio of loans and leases to finance.
The Facility performs its own due diligence.
The Facility co-invests with the institutional aggregator. The Facility's loss exposure is contained to a low risk level.
The Facility's funding commitment is leveraged by the institutional aggregator, leaving more funds in the hands of small originators to finance more leases and loans.

Source: Author.

Another challenge will be related to the choice of assets eligible to be securitized and purchased by the Facility. Restricting eligibility to newly issued loans and leases – as was suggested in a consultation paper from the BDC (2009) – would considerably reduce the availability of assets, and confine eligible assets to those loans and leases issued at higher rates under more stringent market conditions.

The Facility could welcome a proportion of "seasoned" assets, as these older assets have built-in track records, making them generally less risky than newer originations. For the first round of financing, the Facility could expand the pool of eligible assets to include older originations, from August 2007 onward – setting aside perhaps 10 to 20 percent of the early rounds for this purpose. This would kick-start the program by quickly funnelling liquidity into originators' hands and feeding new originations. For the institutional aggregator's model, which is aimed at smaller originators, the Facility could restrict its funding to new leasing activities.

Because the demand for the Facility's funding will exceed its available supply, an allocation mechanism will be required. First, overall funding could be allocated among the investment channels illustrated in Figure 1, based on the respective market share of each category of underlying originators – the large sophisticated issuers, the mid-size and the smallest originators. Then, to be efficient and reduce uncertainty of outcome, funding for new leases and loans should be committed beforehand, based on anticipated capacity. For example, multiple rounds of financing may be organized whereby participants extend commitments to sell securities, at pre-determined rates, create the securities that will be sold to the Facility and then receive their share of funding.[4] For example, each round of financing could happen on a bi-monthly basis for a period of eight months, at which time the Facility's total funding would be exhausted. The Facility would monitor take-up in making further decisions about pricing and allocation.

This process will generate confidence that the conduits and aggregators will be able to finance the receivables they assemble. Purchases by the Facility would take place when conduits and institutional aggregators have met the predetermined requirements, including credit ratings, due diligence, transparency and disclosure needs. In this respect, the Facility should establish a clearly defined and standardized due-diligence process to be followed by regulated issuers.

As to the pricing of risk, the federal government could build on its lower cost of borrowing to provide a pricing structure for these securities that would lead to reductions in the cost of capital for financing companies, and, presumably, for consumers. Historically, the lending spreads[5] on these securities have been lower than 50 basis points (bps; see Figure 2). Since August 2007, they have spiked to very high levels – reaching about 350 bps before falling to about 300 bps – almost entirely freezing market activity.[6] If the government's intention is to restart that market, then pricing would need to be discounted – with lending spreads lower than current spreads by enough to ensure take-up. On top of the government's cost of funds and historical spreads, pricing should reflect to some extent changing economic conditions and underlying risks, and the extra cost of a more stringent due-diligence and reporting process.

From the perspective of the Facility and taxpayers, however, it will be crucial to mitigate market risks, as the value of assets held by the Facility will take up a major share of BDC's balance sheet. The Facility will face incomplete information with respect to the quality of underlying assets, as well as market and economic uncertainty. The Facility would therefore rely on the work of intermediaries such as rating agencies or, arguably, regulated financial institutions, to assess the quality of term securities, while retaining its own duty to perform due diligence.

4 BDC would likely want to impose a penalty fee proportional to commitments, should issuers fail to take up allocations they bid for, so that issuers do not have incentives to strategically overbid for available allocations.

5 Such as the spread between LIBOR or federal treasuries and the yield on AAA bonds backed by floating-rate prime auto loans.

6 Trading activity in ABS in Canada has been almost entirely limited to credit card loans since August 2007; therefore, spreads shown here may not constitute a reliable benchmark for other asset-backed loans and leases.

Figure 2: Spread between AAA-rated Asset-Backed Securities and Government of Canada Bonds, January 1, 1998 to March 11, 2009*

Notes: *AAA-rated Asset-Backed Securities backed by all asset classes with terms less than 5 years and Government of Canada bonds with remaining terms less than 5 years.
Trading activity in ABS in Canada has been almost entirely limited to credit card loans since August 2007.

Source: CIBC World Markets.

For example, in most cases, financing companies that originate loans and leases also collect the payments on those assets. For this reason, buyers of asset-backed securities may face a disruption in the collection of receivables should a financing company or parent auto company collapse. Issuers have generally managed this risk – known as servicing risk – by hiring a backup servicer. Given current market conditions, it is conceivable that a large issuer of ABS may fail, reinforcing the desirability of proper due diligence and planning by the Facility, including arrangements for backup servicers; rating agencies should include backup servicing in their rating and risk analysis. A better, long-term resolution would see the industry create its own, shared backup servicer to provide a form of insurance against the failure of a particular issuer.

Looking Ahead

The success of the proposed Facility cannot be assessed solely on the near-term returns generated on investments. In the short term, the effectiveness of the Facility will depend on the level at which funding is effectively funnelled into more asset-based financing for consumers and businesses. If the Facility proves successful, and market conditions warrant further intervention, the federal government could consider replenishing the pool of capital available in the Facility. The degree to which funds flow through each of the three investment channels, once appropriate risk-management and pricing mechanisms are in place, could indicate where new funding ought be expanded.

Policymakers should be aware, however, that the ABS market chilled in large part because of poor market expectations with respect to the underlying risks – for auto leases, for example, the risk of falling residual values and rising default rates, leading to ABS holders potentially not being able to recoup their investments. If these risks continue to inhibit the securitization market, and policy remains aimed at sustaining that market, then the Facility may need to change course. Rather than directly buying securities, the Facility could insure a significant portion of default risks, or subsidize lending in the style of the US Term ABS Loan Facility, creating a lower-risk term-securities marketplace. Whether it would be appropriate for BDC – or the Canadian taxpayer more broadly – to take on these ordinary market risks is a different question.

From the perspective of investors, improvements in transparency and disclosure with respect to asset composition and performance reporting would improve their ability to assess risk and returns. In this respect, the Facility could offer an opportunity to develop new market standards for these types of securities, aligning the interests of investors and issuers, and providing a new track record on which to build. If recent market conditions for term-ABS are driven by "irrational" fears spreading from other asset classes, the success of the Facility could conceivably improve investors' confidence, creating a sustainable marketplace for this asset class.

Finally, once the Facility is functional, the federal government should revisit the statutory restrictions on federally regulated financial institutions' ability to directly engage in all aspects of leasing activities. In the longer run, additional competition in the marketplace could reduce the cost and increase the availability of lease financing for businesses and consumers.

Reference:

Business Development Bank of Canada. 2009. "Consultation on the Canadian Secured Credit Facility." Available at http://www.bdc.ca.

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